MEMORANDUM FOR: Bill

You were called by Harry Neustein. He wanted to tell you three things:

1. DCI should read editorial in today's WALL STREET JOURNAL by Fred Seeger. (attached)

2. DCI should read article by Mr. Neustein in today's NEW YORK POST on page 53, which says the reverse of the Seeger article. ~~(Public Affrs getting article)~~ (attached)

3. Tell DCI Mr. Neustein is leaving for Geneva next Friday; if he wants to talk to Mr. Neustein it will have to be before then.

Debbie, 18 January

Mr. Neustein

Date

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ON PAGE 22

WALL STREET JOURNAL
18 January 1985

If Oil Price Dives, Leap In With Fee

By S. Fred Singer

What might have seemed sheer speculation in these columns during the height of the "oil crisis" in 1980 may be coming to pass. The Saudi oil minister, Sheik Ahmed Zaki Yamani, has now warned publicly of a possible "price war," which could drive oil prices down toward pre-1974 levels. How low could that price become, how long would it remain at the bottom, and how and why would a price war happen? How will it affect the U.S. economy, the ongoing conservation effort and U.S. energy investments? What, if anything, should the government do during an oil producers' price war?

The possibility of a price war derives from the continuing oil glut, a feature of the world oil market since about 1981. The glut, in turn, is caused by the efforts of the Organization of Petroleum Exporting Countries to maintain the world oil price at the unrealistically high level of $29 a barrel. OPEC hopes to do this by acting as a cartel, i.e., by mutually agreeing to limit production to make oil scarce. But the scheme is not likely to work while excess capacity almost equals OPEC's present output. It is in the interest of each cartel member to cheat by selling additional oil "under the table" to increase its share of the market and increase badly needed revenues. As such selling proliferates and cartel discipline breaks down, the price must fall.

Plan Isn't Working

So far, the brunt of the production cutback has been assumed by Saudi Arabia; starting in 1981 it reduced production from over 10 million barrels per day (mbd) to nearly three mbd, in a futile and mistaken effort to defend the then price level of $34. It can be demonstrated by calculation that the optimum price level for Saudi Arabia, i.e., the one that leads to the highest long-term profit stream, is about $20—well below the current price. As the holder of the largest oil reserves, the Saudis should nudge the price down to this level to protect their future market.

For internal political reasons, the Saudis avoid lowering the nominal price but instead let it erode by inflation; unfortunately for them, this plan is not working, since the dollar has become stronger and inflation weaker. They also have a severe external political problem; their OPEC fellows, most of whom will soon be running out of oil, would much rather keep up the price a little longer by having Saudi Arabia reduce production further. And some of them, like Iraq and Iran, are militarily strong and quite close by.

With these conflicting goals within OPEC the situation could become unstable. Expecting further price decreases, producers would sell as much of their oil as possible at the current higher price, and holders of stockpiles would dump them on the market. But these extra supplies would bring down the price quickly and thus produce a self-fulfilling prophecy.

The driving force is the desire for profits. To give rough numbers: Holders of some 500-million-barrel inventories (for example, many oil companies) would make $5 billion if they could sell quickly and buy back at $10 less per barrel. This collapse scenario is the mirror image of the 1979 events when expectations of oil shortages, fostered largely by pronouncements of the Carter White House, led to panic buying and hoarding, and to a rapidly rising price.

A price collapse either can be kicked off spontaneously, going well below $20 as sellers flood the market—or, as the Saudis have threatened to do, it can be set off deliberately. The Saudis' purpose is to scare OPEC members and get them to stick to agreed-to production quotas or else be undersold. The threat also is designed to keep non-OPEC producers (principally Britain, Norway, Mexico and the U.S.S.R.) from lowering contract prices. Yet another price-war trigger could be the sudden appearance of additional supplies—for example, Iraqi oil that has been held off the market by the Iraq-Iran conflict.

The price collapse may take the following form: OPEC, especially Saudi Arabia, has enough unused production capacity of low-cost oil to drive the price down to $10 to $12 a barrel, at least for several weeks. One arrives at these numbers by estimating how much oil is available at each production cost level, i.e., by estimating a world supply curve. (The supply curve incorporates a hotelling factor that accounts for the opportunity to invest revenues now vs. selling the oil at a future higher price.) The price is then set by its intersection with a world demand curve in a truly competitive market where all low-cost oil wells produce to maximum capacity. The duration of such a collapse should be short, perhaps commensurate with a typical oil-shipping time of two to four weeks. Once oil producers found themselves caught up in a price war, they would resolve to observe strictly their production quotas and the price would rise to near its present level. Of course, if the producers act quickly, the price might not drop all the way to the theoretical $10 level.

The effects of even a brief price collapse could be far-reaching. It would temporarily put out of business oil wells with a marginal production cost greater than about $10 a barrel; this includes most U.S., including Alaskan, oil and also much OPEC oil. Producers of competitive fuels—coal and gas, usually sold under long-term contracts—would experience some difficult moments. Consumers probably would not benefit from the lower world oil price, because competition might not have enough time to work its way through the system. But even a short-lived episode could hurt the continuing conservation effort and certainly give the wrong long-range signals. Consumers should be aware that the price of oil will rise eventually, and certainly be higher than the present price after the year 2000—as low-cost oil gradually becomes depleted, even in Arabia.

Under these circumstances it makes sense for the U.S. (and other oil-importing nations) to take appropriate countermeasures. The preferred action is a variable import fee (VIF) to keep the price of imported oil at some fixed level during the price-collapse episode. Such a fee, applied on a temporary basis, would also stabilize domestic prices for all fuels and keep the situation unchanged for domestic producers and consumers—as if the price collapse had not occurred.

Some care has to be taken in applying a VIF, so as not to discourage competition among oil buyers to get the lowest price on the world market. Such procedures are not too difficult to work out. For example, the VIF could be set periodically as the difference between a fixed target price (set by Congress, at say, $25) and a world-averaged spot market price. Oil importers would profit if they could purchase at less than the average price.

It is quite appropriate to think of the VIF as a countervailing tariff applied against the dumping of a commodity—a well-accepted legal procedure. The overall effect of the VIF would be to transfer profits from foreign oil producers and oil brokers to the U.S. Treasury, without raising consumer prices. It would also protect the investments of thousands of energy producers (some 15,000 oil producers in the U.S.) and Treasury revenues derived from the windfall tax (which would cease if the domestic price drops below about $18).

Continued

Most Difficult Problem

It is appropriate for all industrialized nations (most of whom are represented in the International Energy Agency) to take coordinated action on individual national import fees to avoid competition in exported goods based on energy price differentials. Further, such action by the IEA would ensure that the world consumption of oil not increase, even if the price collapses. Of course, oil companies around the world would take advantage of bargain spot prices to replenish inventories, and take a profit later when oil prices recover. But their profit comes out of the pocket of oil producers, not consumers.

By far the most difficult problem will be to convince consumers that the VIF is not a tariff, is strictly temporary, and will lead to lower prices of world oil in the medium and long run by constraining oil demand through conservation. It is not difficult to see that if the Treasury refunds VIF revenues via a tax reduction, the average oil consumer qua taxpayer will also derive short-term benefits from an oil producers' price war.

Mr. Singer is a visiting professor at George Mason University in Virginia. His latest book is "Free Market Energy," published last year by Universe Books.

ARTICLE APPEARED ON PAGE 53

NEW YORK POST
18 January 1985

Saudis hold key to OPEC collapse

YOUR BUSINESS
With Maxwell Newton

THE deterioration in the world oil markets has raised the question. Will the Saudis decide to abandon OPEC and go it alone?

Before leaving for Geneva and yet another meeting of the Organization of Petroleum Exporting Countries this week, our oil correspondent, Harry Neustein, said the anwer to that question is, "No."

"Yamani is too scared to go free market," said Neustein, "He is terrified of what the Iranians would do to him."

On top of OPEC's existing troubles, he said, there is a prospect of another 1½ million barrels a day of crude oil coming on to the market in 1985 from numerous small producers outside OPEC, such as Egypt, Angola and Malaysia.

Due to the deterioration in the oil markets, Neustein observes, crude is no longer the market that dominates. The dominant markets are for oil products, where barter, long credit terms and other devices are being used to make hidden cuts in prices.

Among the smartest people in this situation are the Russians, who are selling everyone else's oil, bartering technology for oil and depriving their own consumers of oil in an industrial society where issues like pollution and environmental concerns are simply not allowed to have free expression.

Commenting on these same issues, the "Petroleum Market Forecast," published in Maryland by the Energy Futures Group, said last week:

"The next six months will be crucial to OPEC's survival. Without strict volume controls, the cartel cannot function in this environment of stagnant demand and intensive competition. Oil related barter deals are increasing and the growth of OPEC export refineries is making a shambles out of any official oil price structure.

"It is, in fact, entirely possible that sometime in 1985 Saudi Arabia may conclude that its long-term interests lie with lower prices and higher volume in order to preserve its long-term markets. If this decision were made, the most critical member of OPEC would then openly undercut the organization, something which it has been doing gradually and quietly for the past 18 months."

Neustein points to two groups which will suffer more than most from the present combination of circumstances:

First, there are the bigger producers outside OPEC who are abiding by the OPEC rules. Mexico is the most important example of this attitude. Egypt is another. These countries will lose markets by supporting official OPEC prices that the OPEC members themselves are not obeying. As the oil markets deteriorate, says Neustein, "Mexico and Egypt will be waiting to hear from OPEC. They'll hear by long distance — a very long distance."

Secondly, there are the major American corporations who bought oil companies for their reserves, only to find the reserves are over-priced. Neustein cites the following:

- Chevron bought Gulf.
- Texaco bought Getty.
- Du Pont bought Conoco.
- U.S.Steel bought Marathon.
- Occidental bought Cities Service.

These companies, says Neustein, paid too much for the reserves and borrowed a lot of money to buy the oil companies concerned.

Now they must sell assets — other businesses they own — in order to finance the enormous debt burdens they assumed.

In my view, one thing could turn the world oil markets around. That is a major change in Federal Reserve policy towards much more vigorous growth in the money supply.

Before the Fed freeze on money growth in 1981-1982, heating oil futures were up around 100. They bottomed out at 70 in the March quarter of 1983. Then, in response to the stimulus from the Fed's strongly expansionary monetary policy in 1982-1983, they rose to about 80 during 1983-1984. But, as 1984 has proceeded, they fell back to the low 70s.

Until there is a major change in Fed policy, the world oil markets will teeter on the edge of collapse.

As the "Petroleum Market Forecast" concluded:

"In the final analysis, 1985 may well be a watershed year in the oil business, with OPEC in a 'make-or-break' position."

HARRY NEUSTEIN
"Yamani too scared."